Research Department
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Tumbling Gold

September was a calamitous month for gold bugs. Within a month, the price of gold nose-dived from $160 to $129 per ounce. Although prices later recovered, the steep decline left a hollow feeling that the market might be a bottomless pit. Financial analysts correctly attributed the decline to decisions on gold reached at the August meeting of the Interim Committee of the Governors of the International Monetary Fund.

IMF decisions

The Interim Committee's decisions were indeed momentous. First, the Committee recommended the abolition of the official price of gold, which had been set at $42.22 per ounce since the second devaluation of the U.S. dollar in February, 1973. Second, it recommended removal of all the obligations under the IMF Articles of Agreement requiring the use of gold in transactions between members and the Fund. Third, the group agreed that the IMF should return one-sixth of its 153 million ounces of gold to members and should sell off another one-sixth at the market price, with the profit from the sale to be used to benefit the developing nations.

In a parallel action, the Group of Ten (Belgium, Canada, France, West Germany, Italy, Japan, Netherlands, Sweden, U.K., and U.S.) agreed for a period of two years, (a) not to peg the price of gold, (b) not to increase the total official stock of gold now in the hands of the IMF and the Group 10 countries, and (c) to abide by any further conditions governing gold arising from future meetings of their central-bank representatives.

In a formal sense, the Interim Committee's decisions were merely recommendations to amend the IMF Articles of Agreement. Before becoming effective, the entire amendment process would take at least eighteen months.

In fact, however, the impact of the Interim Committee's decisions will be felt much sooner. Because of the Committee's wide national representation—eleven major industrial nations and ten developing nations—as well as the Governors' favorable response, ultimate ratification of the proposed amendments is a foregone conclusion. Ways may be found to short-cut the amendment process by arrangements which would permit the IMF to carry out the proposed measures. Moreover, events of the past four years have outstripped the IMF Articles of Agreement. Few members will feel constrained to conduct gold transactions any longer at the official price of $42.22 per ounce.

Since mid-1972 the market price of gold has stayed well above the unrealistic official price. As a result, official gold holdings, including those of the IMF and national monetary authorities, have been effectively frozen. The abolition of the official gold price thus frees the reserves for international transfers.

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Some have hailed the decision as a move towards reactivation of gold reserves for payment purposes. The IMF Governor for South Africa, for instance, predicted that "gold will be as sought-after as ever as an element of strength in an unstable world." Others, however, were not as sanguine, arguing that the freeing of gold reserves could bring about an avalanche of gold onto the market. The critical question is thus what this development portends for the future of the gold market.

Gold as a store of value

Advocates of gold stress its historical role as a universally accepted store of value. Especially during times of war, uncertainty, and inflation, gold provides a haven for the savings of both rich and poor. For national governments, the fear of foreign-exchange assets being frozen or expropriated by hostile foreign authorities reinforces the argument for keeping national reserves partly in gold. Gold bugs predict that the trend of gold prices will depend primarily on the expected rate of world inflation and the expected degree of political disturbances. To the extent that the future is clouded with uncertainty and threatened with instability, individuals and governments will not only hang on to their gold but will even demand more.

The gold bugs' basic premise is that gold will continue to be a safe haven for personal and national savings. It is that very premise which needs to be re-examined in view of the recent IMF and Group-10 decisions.

Gold's universal popularity extends far back into history. For centuries and in many lands, gold was used either directly as money or indirectly as a backing of national monies. Even in the present century, when one after another national currency lost its gold backing, gold continued to serve as an international means of payments at a fixed price in terms of some key international currency. For most of the period from 1717 to 1934, gold could be converted into the British pound at the equivalent rate of $20 per ounce; from 1934 to 1971, it could be converted into the U.S. dollar at the rate of $35 per ounce. Thus, for centuries, gold was considered a safe store of value because of its assured convertibility into a key international currency at *a fixed rate.*

Gold's universal value stemmed primarily from its backing by a key international currency, which had relatively stable purchasing power over goods and services everywhere—not merely in the country of its origin. It is a common misconception—a sort of cart-before-horse thinking—to hold that a key international currency is

made so because it is backed by gold, which in turn possesses an "intrinsic" value because of its general acceptability.

Gold cut adrift

So long as the dollar possessed relatively stable purchasing power, gold tied to the dollar provided a relatively safe store of value. However, as inflation accelerated in the U.S. in the late 1960's, gold was no longer such a safe asset. The U.S. monetary authorities had then two possible options—(a) raise the official price of gold, so as to preserve the purchasing power of gold, and (b) cut the link between the dollar and gold, permitting gold to find its own price in the market. In fact, the U.S. Treasury did both. It suspended gold convertibility of the dollar in August 1971, and subsequently raised the official price of gold first to $38 per ounce and then to $42.22 per ounce. However, since the dollar was no longer convertible into gold, the official price of gold had little meaning in relation to its real purchasing power.

Cut loose from its moorings, the market price of gold shot sky-high, reaching $195 per ounce at year-end 1974. Most of the driving force came from speculative demand, as industrial use accounted for merely 40 percent of the 1,180 metric tons supplied to the market in 1974. But gold prices then dropped precipitously in 1975. Without official price pegging, gold has become a highly risky asset.

Because of the recent IMF and Group-10 decisions, gold has lost its monetary support for the foreseeable future. Unless repegged to an international currency, it will float entirely on its own, with its price continually buffeted by current market sentiment. The precariousness of this market is enhanced by the existence of a huge gold stock in private and official hands, relative to the volume of current production and consumption. In such a market, stability is constantly threatened by what might happen to that overhanging stock. Indeed, under the present circumstances, it is difficult to conceive of a less safe store of value than gold.

The advocates of gold may be mistaken in their indiscriminate trust in the "intrinsic" value of gold, but they are correct in their belief in the social function of gold amid conditions of uncertainty. Individuals and governments alike need a safe store of savings in this imperfect world. Even with the SDR, one may question if the world's finance ministers and central-bank governors have developed an international financial asset capable of fulfilling all the functions which gold performed in the past.

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